BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
SAN CHRISTINA INVESTMENT COMPANY)
CITY INVESTMENT COMPANY, MISSION)
CONSOLIDATED REALTY COMPANY and )
UNIVERSAL COMPANY )

Appearances:

For Appellants: Charles S. Wheeler, Charles S. Wheeler, Jr., Walter Slack, Cushing and Cushing
For Respondent: Reynold E. Blight, Franchise Tax Commissioner; A. A. Manship, Assistant Franchise Tax Commissioner; H. H. Linney, Deputy Attorney General; Frank L. Guerena

## O P I N I O N

Appellants were affiliated corporations within the meaning of Section 14 of the Bank and Corporation Franchise Tax Act (Chap. 13, Stats, 1929) and, pursuant to that Act filed a consolidated return covering their business for the year ended December 31, 1928. Thereafter, the Franchise Tax Commissioner notified them of his proposal to assess an additional tax under. Section 25 of the Act. The determination of the correct amount of the tax is now before this Board upon an appeal following the refusal of the Commissioner to modify his action.

To effectuate a plan of re-organization, in September, 1929 Appellants caused to be organized under the laws of this State, a corporation named City Investments, Ltd., and thereupon transferred and assigned to that corporation any and all moneys due or to become due to the Appellants, In December, 1929, pursuant to proceedings instituted in the Superior Court for the City and County of San Francisco, each of the Appellants was dissolve

To secure the decrees of dissolution the Appellant corporations found it necessary to pay (under protest) the amount of additional tax assessed by-the Commissioner, as Section 29 of the Act appears to make such payment a condition precedent to the entry of the decrees. As the successor of the Appellant corporations within the meaning of Section 27 of the Act, City Investments, Ltd. is asking for the refund of whatever exaction from them may be determined by this Board to have been excessive

Three grounds are urged as the basis for this appeal:

1. That the Franchise Tax Commissioner erred in refusing to allow as a deduction', in his computation of net income of the Appellants for the year 1928, the sum of $50,889.48, representing the amount of a judgment which became final against the

Universal Company in that year.

2. That the Franchise Tax Commissioner erred in refusing to accept the actual cost of certain real property acquired by the Mission Consolidated Realty Company in 1914 as the basis for determination of the loss sustained upon the sale of such property in 1928.

3. That the Franchise Tax Commissioner erred in his computation of the proposed additional assessment by refusing to recognize the validity of the contention of the Appellants that they could be taxed only for the privilege of exercising their respective franchises from July 1, 1929 to December 31, 1929, and that their tax should be measured, accordingly, by only one-half of their income for the 'preceding calendar year.

We shall consider the grounds urged in the order of their enumeration, and, therefore, shall discuss first the question of the deductibility of the judgment mentioned. The pertinent provisions of the law on the subject are to be found in Sections 8 and.10 of the Act.

In part, Section 8 provides:

"In computing 'net income' the following deductions shall be allowed:

"(d) Losses sustained during the taxable year and not compensated for by insurance or otherwise-----."

Section 12 contains this provision:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period, fiscal year or calendar year as the case may be, in accordance with the method of accounting regularly employed in keeping the books of such taxpayer-----."

The language of Section 8 is similar to that of Section 234(a) (4th) of Federal Revenue Act of 1918 (40 Stat. at L. 1057), and the provision of Section 12 quoted is analogous to Section 212(b) of this same federal act.

Under Section 234(a) (4th) of the Revenue Act of 1918 (Supra), it has been held that a judgment against a corporation for a breach of contract is deductible as a loss. (Lucas v. American Code Co. Inc., 50 Sup. Ct. Rep. 202).

In the instant case, the Universal Company was sued for failure to pay certain balances claimed against it by the Pacific Gas and Electric Company on account of electrical energy for the purchase of which the Universal Company had contracted. The electricity was delivered during 1920, 1921, and 1922. Judgment was rendered against the Universal Company in 1926, but an appeal was taken and this judgment did not become final until 1928, when it was paid.

Both the Appellants and the Commissioner seem to have proceeded upon the theory that a charge of this kind, if allowable as a deduction from gross income to arrive at the net, is to be regarded as coming within the purview of subdivision(a) of Section 8 of the Act. This subdivision provides for the deduction of

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on business-----."

The Appellants contend that the judgment is deductible as an "ordinary and necessary expense" of their business, while the Commissioner advances the view that "a judgment resolving a dispute under a contract for the supply of power cannot fairly be regarded as an 'ordinary' expense."

With this divergence of views we are not greatly concerned. In the absence of an interpretation of Section 8 of the Act by the courts of this state,we regard as controlling the holding of the federal courts with reference to the analogous provision: of Section 234(a) (4th) of the Revenue Act of 1918 (Supra).

We have already observed, the federal courts have held that a judgment against a corporation for a breach of contract is deductible as a loss. There is provision in subdivision (d) of Section 8 of the Act for the deduction of a loss sustained by a corporation and we think that the judgment rendered against the Universal Company comes within that category.

However, it becomes important to determine whether or not this particular judgment represents a loss sustained "during the taxable year" as specified by subdivision (d) of Section 8 of the Act. Again we must turn to federal precedents, since the courts of our state have never passed upon this provision of our law. The terms of Section 12 of the Act are parallel to those of Section 212(b) of the Revenue Act of 1918 (Supra), as we have already pointed out.

There seem'to have been two theories applicable to the problem of when a judgment may be deducted as a loss. Some cases hold that the time for making the deduction is the year in which the judgment was rendered; others that the proper time for the deduction is the year in which the judgment becomes final.

In those cases holding that a judgment is to be deducted when it is rendered, there have always been unusual circumstances such as admission of liability or creation of a fund for the payment of the judgment. (Becker Bros. v. U. S., 7 Fed. (2d) 3; Malleable Iron Range Co. v. 65 S.Ct., Cl. 441). If there is no definite admission of liability or other special circumstance of that type, and the judgment is appealed, it cannot be said that the taxpayer has suffered a loss until the case is affirmed on appeal. (Consolidated Tea Co. v. Bowers, 19 Fed. (2d) 382; Lucas v. American Code Co. Inc., 74 L. ed (adv) 296, reversing the decision of the Circuit Court in 30 Fed. (2d) 222)

The Franchise Tax Commissioner cites the case of Providence Coal Co. v. Lucas, 39 Fed. (2d) 109, decided by the United States District Court on February 6, 1930, as sustaining his position that the judgment against the Universal.Company is not deductible in 1928. The authority of that case is weakened by the fact that the United States Supreme Court decided the American Coce Company case (Supra) on February 24, 1930, and established a standard for the allowance of a deduction in the year of the breach as follows:

"In the few cases in which the Board of Tax Appeals has allowed a deduction in the year of the breach, the contracts, involving the purchase and sale of goods, were performable in a comparatively short period; the approximate amount of damages was reasonably predictable; negotiations for settlement had been commenced within the year and were completed soon after its close; and the taxpayers had accrued on their books, at the end of the year, a liability reasonably estimated to equal the amour of the damages."

The facts in the appeal before our Board seem to bring the case squarely within the rule established by the Supreme Court holding that, ordinarily, a judgment is deductible as a loss in the year in which it becomes final. In the case under considera tion the breach of contract occurred in 1920, 1921 and 1922. Suit was instituted and judgment rendered in 1926. An appeal wa taken and the judgment was affirmed in 1928. The Universal Company at all times vigorously contested the validity of the 1926 judgment, and, according to the evidence before us, never admitted liability. It is stated that the company was so con- vinced that it was right that no accrual was made in 1926 on the books of the corporation to pay the claim in the event of an adverse decision.

As in the case of the Consolidated Tea Company, supra, the corporation did not part with the money until the judgment was affirmed. During the interim between the rendering of the judg- ment and the final determination of the appeal, the company had the use of the money. To call the judgment a "loss" sustained in 1926 seems illogical and contrary to the facts; Therefore, we conclude that the amount of the judgment against the Universe Company is deductible as a loss in arriving at the net income for 1928.

Turning to the second point urged upon this appeal, we find Mission Consolidated Realty Company, one of the Appellants, claims that the Commissioner should have considered the actual cost of real property in San Francisco acquired by it in 1914 as the basis for the determination of the loss sustained upon the sale of the property in 1928. According to the evidence before us the original purchase price of the property was $116,261.44, and after deduction of depreciation of $11,735.75 written off between 1914 and 1928, the Appellants arrive at a value of $104,525.69 as of January 1, 1928. The property was sold in 1928 for $65,000.00 so that the Appellants computed a loss of $39,525.69.

The pertinent provisions of the law on the subject are to be found in Section 19 of the Act, which reads in part as follow

"For the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of property, real, personal or mixed --------in the case of property acquired prior to January 1, 1928, and disposed of thereafter, the basis shall be the fair market value thereof as of said date."

From the foregoing it is apparent that the question for determination is whether or not the method for determining valu as of January 1, 1928 urged by the taxpayer is designed to fulfill the requirement that "the basis shall be the fair market value thereof as of said date." In similar questions arising under the Federal Revenue Act it has been held that the phrase "fair market value" does not relate necessarily to cost or depreciation.

In the Appeal of Rockford Malleable Iron Works, 2 B. T. A. 817, it is said:

"Value is a real, actual, definite thing and, in many instances, cost or depreciation, or both, have very little to do with it. Value is what the property is worth. It is what it would bring in the open market if offered for sale by an owner willing, but not compelled, to sell to a purchaser willing, but not compelled, to buy. Value is frequently affected by things. far removed from depreciation or cost."

See, also, Appeal of Hart Cotton Mills, 2 B. T. A. 973; Appeal of Stokes Milling Co., 2 B. T. A. 1284.

It is essential to the establishment of a "fair market value" that evidence be heard. (Heiner v. Crosby, 24 Fed. (2d) 191.) The precise date of sale of the property does not appear from anything submitted to us by the Appellants. From all the evidence before this Board the fact may be that the property was sold very shortly after January 1, 1928. Its price would certainly be a good indication of its "fair market value", in the absence of anything showing that the sale was influenced by abnormal factors. Therefore, we conclude that the Appellants have failed to show error in the Commissioner's ruling with regard to the alleged loss upon the sale of the property.

The third point raised by the Appellants relates to what is described as an "overlap" between the taxes imposed under Chapter 13, Statutes 1929, and those previously levied under Section 3664a of the Political Code. It is contended that the Bank and Corporation Franchise Tax Act (Supra) is unconstitutio insofar as it attempts to impose a tax on the privilege of doing business during the months covered by tax payments made under Section 3669 of the Political Code. Relying upon the language used in receipts issued by the State Controller pursuant to that section, Appellants say that taxes paid on their corporate franchises, according to assessments made by our Board as of the first Monday in March, 1928, were for the fiscal year ended June 30, 1929. Because Section 16 of Article XIII of the

Constitution, under which the taxes questioned in this proceeding are imposed specifies that they shall be "in lieu" of the taxes on corporate franchises, the Appellants conclude that it is unconstitutional to assess the new tax for any time prior to July 1, 1929.

There is nothing in Section 3669 of the Political Code specifying that the corporate franchise taxes assessed under Section 3664d of the same code are to "cover" any particular period. So far as we are aware, there is no such provision else where in the laws. As a fundamental proposition all property taxes in California are annual and relate to assessments to be made as of the first Monday in March. (Const. Art. XIII, Sec. 8). Corporate franchise taxes assessed under Section 3664d of the Political Code are property taxes. (People v. Alaska Pacific S. S. Co., 182 Cal. 202). They become a lien on the first Monday in March of each year and the value of the franchises to which they attach is fixed as of that date, (Const. Art. XIII, Sec. 14(f)).

While it is true that the taxes assessed as of the first Monday in March may not be "due and payable" until the first Monday in July thereafter (Const. Art. XII, Sec. 14(f)), they accrue on the assessment date and a subsequent change in the status of the property, even prior to the due date, would not affect the liability for them. (Estate of Backesto, 63 Cal, App. 265). Thus, it has been common practice of our Board to require a corporation dissolving after the first Monday in March and before the first Monday in July to pay a tax on the value of its general corporate franchise as of the first Monday in March, in order to discharge its tax obligation to the state.

When what is now Section 16 of Article XIII of the Constitution was drafted in 1928 it was apparently oriented on the same assessment date, because in referring to the taxes to be levied thereunder it provides that "said taxes shall become a lien on the first Monday in March of 1929 and of each year thereafter." However, the enabling statute proposed by the authors of the plan for the new corporation tax calls for the payment of taxes on the basis of a "taxable year," and from the provisions relating to the inauguration of the plan, it is plain that taxation of corporations for the privilege of doing business from and after January 1, 1929, is contemplated. (Stats. 1929, Chap. 13, Secs. 4, 11, 12 and 13). The tax is made a lien as of the first Monday in March of each year, although in the cases of corporations with fiscal years it is not clear to which first Monday in Match the lien relates. (Stats. 1929, Chap. 13, Sec. 29).

Therefore, we are confronted with the anomalous situation of a tax apparently intended to accrue on one date and become a lien on another. Certainly, a literal interpretation of the provisions of the Act to which we have referred indicates that the first taxes of Appellants thereunder are to be based on the net income for the entire year 1928 and are for the privilege o

doing business in their respective corporate capacities for the entire year 1929. It might have been assumed that the "in lieu" provisions of the constitutional amendment adopted in 1928 (Const. Art. XIII, Sec. 16) meant that in the place of the corporate franchise tax which would become a lien on the first Monday in March of 1929, there would be this substitute "privilege" tax accruing and becoming a lien on the same date.

While we are not convinced that the payment of 1928 corporate franchise taxes "covered" the period expiring June 30, 1929 it does seem apparent to us that *no* further corporate franchise taxes could have accrued prior to the first Monday in March of 1929. Therefore, any other taxes accruing before that date must be regarded as overlapping the 1928 general corporate franchise taxes. However, *we* do not believe that it follows necessarily that the overlapping taxes are unconstitutional, even though they may involve a paractical duplication.

There is no constitutional inhibition of the passage of retroactive laws in this State. In the absence of such a provision, there is no inherent invalidity in retroactive income or excise taxation. (Stockdale v. Atlantic Ins. Co., 20 Wall, (U. S.) 323, 22 L. ed. 348; Brushaler v. Union Pacific, 240 U. S. 1, 60 L. ed. 493 and cases cited in 11 A. L. R. 518). Theoretically, at least, the tax "according to or measured by" net income imposed under the Act is an excise tax. Perhaps it is an income tax. (Macallen v. Massachusetts, 279 U. S. 620). Probably it is not a property tax, although it is expected to replace one.

While the fairness of the overlap may be dubious, apparent: there is no constitutional objection to imposing an excise tax and a property tax simultaneously on corporations. This was done during the period from 1915 to 1927, when the corporation license tax based upon the authorized capitalization and the general corporate franchise tax were both in effect. Section 16 of Article XIII of the Constitution provides that the new "excise" tax shall be in lieu of the old property tax, but that, in effect, is a suspension of the old coincident with the adoption of the new, and not necessarily a limitation upon the time when the new tax may begin to operate. (Hunter v. City of Memphis (Tenn)26 S. W. 828; Tennessee v. Bank of Commerce, 53 Fed. **73%**

In view of the these considerations, we conclude that although the tax which the Commissioner proposes to assess against the Appellants does overlap their 1928 corporate franchise taxes to the extent of the period between January 1 and March 4, 1929, there is no constitutional provision prohibiting this,

## O R D E R

Pursuant to the views expressed in the opfnion of the

Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, that the action of Reynold E. Blight, in overruling the protest of San Christina Investment Company, City Investment Company, Mission Consolidated Realty Company and Universal Company against a proposed additional assessment based upon their consolidated return for the year ended December 31, 1928, under Chapter 13, Statutes of 1929, be and the same is hereby reversed as to his disallowance as a deduction in computing net income for that year a judgment for $50,889.48 becoming final against Universal Company in 1928; it is further ordered, adjudged and decreed that the action of said Commissioner be sustained as to all other objections made to it by said Appellants. Said Commissioner is hereby ordered to modify his proposed additional assessment and to proceed in conformity with this order.

Done at Sacramento, California, this 4th day of August, 1930, by the State Board of Equalization.

R. E. Collins, Chairman
H. G, Cattell, Member
Jno. C. Corbett., Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary